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A word about oil and gas securities

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Jim Edgar
Secretary of State
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Understanding "the deal"

Before committing yourself to any oil or gas investment, it is important to understand how the revenue, if any, will be divided among the promoter and royalty and working interest owners. "Overriding royalty interests" are computed as a percentage of gross revenues. Owners, usually the landowners, are paid their share without deduction for costs or expenses and before payment to working interest owners. "Working interests" entitle the owner only to a percentage of net revenue after deduction for royalty interests. Costs and expenses may be deducted also or may be billed separately to the working interest owners. The promoter may retain some working interests for himself without making a cash contribution. You should find out:

- How many royalty interests are involved
- How many working interests are being sold
- If anyone is receiving free working interests
- If the promoter is risking his own capital
- How much the promoter makes if the well is a dry hole.

Our experience indicates that royalty interests may run as high as one-eighth to one-fourth of revenue.

Make sure the promoter furnishes you with enough facts to make an informed investment decision. In addition, the Illinois State Geological Survey provides oil and gas development maps on which you can find the locations of all holes drilled in the state, their depth and production areas.

The completion decision

After the well has been drilled, the promoter will decide whether to "complete" the well and try to pump oil or gas. If he decides to proceed, he will contact investors for completion money.

Investors are not bound to provide completion money. They have the option to terminate their involvement at this point. Investors who choose not to participate in completion will not be entitled to any profits if the well is successful, but their losses will be limited to their initial investment if the project fails. The mechanics of the completion decision should be spelled out in the contract between the promoter and the investor.

If you decide to participate in the completion, base your decision on sound geological information, which the promoter should provide to you. Be wary of promoters whose sole reason to complete is the success of nearby wells or speculation based on "past experience."

No one can predict, based on drilling only, how much a well will produce or that it will produce at all. Equipping the well for completion does not mean that the well actually will pump oil or gas. It simply means the **promoter has decided to try** to pump oil or gas.

A major expense of any completion attempt is the investment in **equipment**. As an investor, you should know if the promoter is purchasing new or used equipment. Fraudulent promoters have been known to collect money for new equipment but actually buy used materials and keep the difference.

Be sure to ask what happens to the equipment if the well is plugged. Most legitimate operations will sell equipment and divide the net proceeds on a pro rata basis among the working interest owners.

Additional investor tips

- Ask for a prospectus or written statement containing history and operations, geological information, risk factors, financial statements and a listing of key personnel.
- Get a written contract.
- Seek advice from an independent professional as to whether this type of investment is a good investment for you. An investor's financial condition determines the tax consequences of the investment.
- Insist on seeing a copy of the contract with the driller. You should understand charges and rig time. Determine the drilling costs by multiplying the cost per foot by the anticipated depth of the well.
- Visit the drill site, if possible.
- Check with the Department of Mines and Minerals in Springfield, Illinois, to find out about other wells under the same operator.
- Do not rely solely on reports of initial production when deciding whether to invest. Initial production of a well is often high and therefore misleading.
- Contact the Illinois Securities Department to determine if the company or individual is properly licensed or has any history of trouble with authorities.

Investment in oil and gas exploration involves a high degree of risk. Investors should be able to afford losing their entire investment. There are no guarantees.

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Oil & Gas Investments

Nearly 80 percent of the complaints filed with the Secretary of State's Securities Department involve oil or gas investments. Illinois' rich natural resources, combined with the demand for these resources and a potentially high return, have made this type of investment particularly attractive.

Although they vary in degree of risk, most oil and gas investment opportunities are legitimate, marketed in a businesslike manner and operated prudently. Our attention is focused on the small number of promoters engaging in fraudulent practices.

In many cases, investors are guaranteed quick profits by investing in oil and gas drilling programs. Fraudulent securities either may be sold in wells that are never drilled or in wells for which the production capabilities are grossly misrepresented. Several different investors may be sold the same interests. In most cases, high pressure sales techniques and misleading projections accompany the offer.

Take a moment to be sure you understand "the deal" and your options in the completion decision. Be an informed investor **before** you make an investment.

Jim Edgar

Jim Edgar
Secretary of State

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Jim Edgar
Secretary of State
Securities Department

For further information, contact:

Secretary of State
Securities Department

900 S. Spring Street
Springfield, IL 62704
(217) 785-4948 or 4940

188 W. Randolph Street
Room 426
Chicago, IL 60601
(312) 793-3384

Toll-free Hotline
1 (800) 252-8980

Printed by Authority of the
State of Illinois
April 1986 — 25M — GA-1197